

October 16, 2002

Marlene H. Dortch
Secretary
Federal Communications Commission
TW-A325
445 Twelfth St., SW
Washington, DC 20554

Re: *Supplement to Notice of Ex parte* presentation in: MB Docket No. 02-70

Dear Ms. Dortch:

On October 16, 2002, I submitted a *notice of oral ex parte presentation* of a meeting that took place on October 15, 2002. At that meeting, the participants discussed a September 16 article in *Electronic Media* which detailed terms of the agreement between AOL Time Warner, AT&T, and Comcast. A copy of the article is attached as a supplement to the *ex parte* filed earlier today.

In accordance with Section 1.1206(b), 47 C.F.R. § 1.1206, this letter is being filed electronically with your office today.

Respectfully submitted

Harold Feld
Associate Director

cc: Ken Ferree
Royce Sherlock
Jim Bird
Nandan Joshi
Erin Dozier

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Deals

Comcast makes out; AOL TW works it out
Diane Mermigas

In their recently announced Time Warner Entertainment settlement, what both AOL Time Warner and AT&T-Comcast left on the negotiating table-and the restrictions on what each "won"-are more telling than anything else revealed so far.

With billions of dollars at risk and the opportunity to set a business precedent, the protracted negotiations between AOL Time Warner and the new AT&T-Comcast gave both companies what they needed, but also, in some cases, left them wanting.

AOL Time Warner got its first critical Internet Service Provider agreement with a nonaffiliated cable operator and the right to boast about unraveling its long-suffering TWE partnership.

For its part, AT&T-Comcast, which will complete its \$50 billion-plus merger by early November, got much-needed cash out of the deal. It initially can walk away with as much as \$4 billion in cash and can eventually sell a 21 percent stake in a newly formed Time Warner Cable company, worth about \$6 billion even in today's weak cable values. Despite circumstances and timing working in its favor, Comcast also won high marks for demonstrating it is a strong, savvy negotiator.

But well-placed industry sources said both companies made notable compromises that could have future implications.

Originally, Comcast wanted all cash for AT&T's 27 percent stake in TWE, then valued at between \$8 billion and \$10 billion, well-informed sources said. AOL Time Warner flatly refused.

Instead, when the TWE deal closes, what AT&T-Comcast gets is \$2.1 billion in cash upfront and \$1.5 billion in AOL Time Warner stock it can sell.

Debt a concern

The cash is critical for the new AT&T-Comcast, which will be strapped

with about \$30 billion in post-merger debt that quickly will be reduced to \$26 billion to protect the merged company's investment grade rating. Even with an estimated \$2 billion in post-merger costs to upgrade AT&T systems, the combined company has about \$2 billion in noncore cable, AT&T stock and Sprint PCS assets it can sell to reduce debt even if it decides to hold on to its AOL Time Warner stock until it appreciates in an improved stock market.

Comcast officials said they got what they needed out of the TWE deal to create a new merged company balance sheet leveraged at a low 3.5 times \$7.5 billion cash flow to debt. Comcast officials who led the negotiations protected the merged company's downside risks in a nonexclusive three-year ISP arrangement with AOL that required AOL Time Warner to make some major compromises.

In what was supposed to be a sparkling template for ISP pacts with other cable operators, and a pillar of its evolving broadband service, AOL Time Warner began negotiations asking for lucrative carriage renewals for its Turner cable network and HBO programming units. Comcast official flatly refused, sources said.

The AOL Time Warner brain trust also was adamant about controlling the subscribers it signed for its AOL broadband and other services, such as subscription music, subscription video and home networking, sources said.

But that didn't happen, either.

AT&T-Comcast not only retains control of the billing and customer service, but sources said that the new pact also prohibits AOL from offering any service that would directly compete with AT&T-Comcast's digital cable content, such as streaming video. That is a very big deal, considering that the ability to layer on new music, video, home networking and other subscription services is what eventually will make and keep AOL broadband profitable.

AOL Time Warner anchored its now-rocky merger on the premise that it can generate boundless profits "mining" its collective 155 million cross-media subscribers (which include AOL, magazines and cable) with new services, content and marketing. Without freedom to do so in cable's broadband arena, AOL is just another ISP.

AOL Time Warner also did not gain access to as much of AT&T-Comcast's new "footprint" as it originally sought.

To survive the transition from narrowband to broadband, AOL needs access to more than Time Warner Cable's 13 million cable subscribers, only about 20 percent of which it has captured with its broadband service, sources said.

But the new AT&T-Comcast initially will limit AOL's ISP access to only one-third of its combined 22 million-subscriber footprint. At best, AOL will only have access to 10 million homes, which could eventually be expanded to 19 million of AT&T-Comcast's combined 38 million-home

platform. "This leaves a sizeable gap in AOL's potential coverage across the nation's largest cable operator," observes Merrill Lynch analyst Jessica Reif Cohen.

That said, AOL's most formidable challenge may be proving itself in the broadband arena by being able to drive its applications into the mass market. Access to Time Warner's 16 percent of U.S. cable homes passed and ATT-Comcast's slice of 10 percent homes passed still trails compared with AOL's 40 percent market share of the stagnating narrowband market.

AOL currently is working overtime to create unique and more compelling broadband product and services in an effort to reinvent the online service in the same way that Time Warner's subscriber-based HBO has been successfully transformed, insiders said.

But because AOL Time Warner failed to raise the bar on terms for third-party ISP agreements, it will have to work even harder for its new pact with AT&T-Comcast to generate the funds to subsidize that process.

That won't be easy given formidable competition from the new broadband services from Microsoft Corp., which has a 5 percent stake and "favored nation" status in AT&T-Comcast. Other ISP competition includes United Online, Earthlink and AT&T-Comcast's new proprietary ISP services.

AOL Time Warner also is under pressure to take its cable entity public within 90 days after the TWE deal closes, after which time Comcast is free to sell all or part of its stake to outside investors, sources said.

Enter John Malone

One tax-free scenario being considered would have John Malone's Liberty Media Group swap its 42 percent stake in QVC, valued at about \$6 billion, for Comcast's 21 percent stake in Time Warner Cable. Liberty already owns 4 percent of AOL Time Warner.

The notion that AOL broadband is a potential "profitability savior" is a "flawed" one unless AOL can drive substantially higher revenues per household through premium services, Ms. Reif Cohen concedes.

The economics of the broadband deal are "inferior" for AOL compared with its narrowband deals, while AT&T-Comcast's profit per subscriber is higher than that from its own ISP services.

Sources said, AT&T-Comcast will get as much as \$38 (\$27 of which is guaranteed) of the \$54.95 paid by subscribers for the ISP broadband service, leaving AOL Time Warner with \$17 per sub to cover its \$7 per subscriber service costs. That leaves an estimated profit of \$10 per subscriber before overhead, marketing, research and development costs.

As a result of Comcast's expert negotiating, Time Warner Cable now is renegotiating its ISP pact with AOL, which generates only about \$27 per subscriber for the cable operator, sources said.

For now, it would the new AT&T-Comcast emerged from the deal with a decisive edge.

"Comcast was able to leverage their customer access into over \$2 billion of cash, \$1.5 billion of stock, and a clear exit strategy. In addition, it was able to negotiate a favorable broadband carriage agreement," Ms. Reif Cohen said. "That's pretty impressive."

---- INDEX REFERENCES ----

COMPANY (TICKER): America Online Inc.; At&T Corp. (AOL T)